Internal Revenue Service

memorandum

CC:TL-N-2189-89
Br3:WEArmstrong

date: FEB 15 1989

to: District Counsel, [redacted] W: [redacted]
Attn: [redacted]

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted]
Taxable Years: [redacted] and [redacted]

This memorandum is in response to your December 9, 1988 letter to the Associate Chief Counsel (Litigation) requesting our views regarding the litigating approach the Service should take in the above case which appears headed for litigation.

ISSUE

Whether the litigating position of the Government should be that the proper "unit of property" or the "single, identifiable property" damaged or destroyed for purposes of computing a casualty loss of timber is the entire tract, the merchantable units of the affected timber (board feet or cords), or some other unit of property.

CONCLUSION

We believe the Industry Specialist and the various components of the Service having an interest in the case should meet to determine whether a litigating position can be formulated which is acceptable to the Service and the Justice Department. If no litigating position is formulated by the Service which is acceptable to Justice and if the litigating alternative proposed by Justice is not acceptable to the Service, we recommend that the casualty loss issue be conceded in the above case; Rev. Rul. 66-9, 1966-1 C.B. 39 and Rev. Rul. 73-51, 1973-1 C.B. 75 be revoked; O.M.s 19516 and 19893 be revoked; and consideration be given to resolving the timber casualty loss issue through legislation.

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FACTS

In your memorandum, you stated that several months ago, [redacted] and Appeals, [redacted] executed a Form 870-AD which resolved all but three issues raised with respect to the [redacted], [redacted], and [redacted] taxable years. Of the unresolved issues, one concerns the casualty loss claimed by [redacted] to its tree farm in [redacted] resulting from the [redacted].

[redacted]'s tree farm was comprised of a total of [redacted] acres and was treated as one "block" for depletion purposes. Although the [redacted] caused by the [redacted] was [redacted], only [redacted] of the total [redacted] acres were affected. The reduction in fair market value caused by [redacted] (perhaps approaching [redacted] dollars) far exceeded the adjusted basis of the tree sub-accounts in the block. Therefore, the amount of [redacted]'s loss will be limited to its adjusted basis in the property.

With regard to its [redacted] return, you stated that [redacted] claimed the entire balance of its basis in the [redacted] acre block, approximately $[redacted], as a casualty loss. This position is based on the judgment of the Court of Claims in Westvaco Corp. v. United States, 639 F.2d 700 (Ct. Cl. 1980), which is adverse to the position urged by the government. However, for financial statement purposes, [redacted] used the same method as the Service in determining the amount of the casualty loss it sustained. The Service, following Rev. Ruls. 66-9, 1966-1 C.B. 89 and 73-51, 1973-1, C.B. 75, Harper v. United States, 396 F.2d 223 (4th Cir. 1968) aff'g per curiam 274 F.Supp. 809 (D.S.C. 1967); and Rosenthal v. Commissioner, 416 F.2d 491 (2d Cir. 1969) aff'g 48 T.C. 515 (1967), allocated the $[redacted] basis between the damaged and undamaged portions of the depletion block, using a unit per acre allocation for merchantable timber and an acre by acre allocation for immature timber. The Service's computation yielded an allowable loss of approximately $[redacted].

[redacted] paid the tax on the [redacted] unagreed issues and filed formal claims for refund in [redacted]. Anticipating that these claims would not be allowed and that [redacted] would file a refund suit in [redacted] in the Claims Court, you informed the Justice Department through the National Office of the need for a meeting to discuss litigating strategy.

In [redacted], you spoke with Mike Dennis, the reviewer in the Claims Court Section of the Department of Justice who has been assigned this matter. Mr. Dennis told you that Mike Paup, the Deputy Assistant Attorney General of the Tax Division, was against relitigating the casualty loss issue in the [redacted] case unless the Service could formulate a new approach along the lines suggested at a June, 1987 meeting. That meeting however adjourned without agreement on what litigating strategy might be productive.

After considering the possible alternatives, Mr. Dennis suggested that the Commissioner give strong consideration to restructuring our position as follows. In place of the traditional approach of measuring the loss by the adjusted basis (for depletion) of the units of timber [redacted], we should measure the loss by the number of cutting units affected. This would necessitate an inquiry into the harvest plans which [redacted] had developed prior to [redacted] and the harvest plans which they implemented after the [redacted]. Mr. Dennis felt that if the case were restructured in this way, the Department of Justice might be willing to relitigate the casualty loss issue. Mr. Dennis felt we should hire an expert with strong academic credentials and, after his study and report were completed, the Service and Justice Department could have a meeting to evaluate the results.

You and [redacted] feel that we should relitigate the casualty loss issue in the Claims Court under the theory of our published revenue rulings (Rev. Ruls. 66-9, 73-51) or we should concede the issue in [redacted] and two other cases pending in appeals, ([redacted] and [redacted]) open a new revenue ruling project, and seek a legislative solution.

You feel there are enough factual differences between Westvaco and [redacted] to warrant another effort in the Claims Court to overturn that unfavorable decision. However, the Department of Justice seems unwilling to relitigate the issue except under a theory that may be watered down. Although you and [redacted] feel that the suggested approach of Mr. Dennis has little value, you both have refrained from giving Mr. Dennis any immediate feedback on his suggestion.

Because you and [redacted] feel that it is time to reach a firm decision regarding whether the Government should relitigate the Westvaco issue in the Claims Court under the theory of our published revenue rulings or concede the issue, you seek at this time our views with respect to the matter.

BACKGROUND

I.R.C. § 165(a) allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. I.R.C. § 165(b) states that the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in I.R.C. § 1011 for determining the loss from the sale or other disposition of property. Under I.R.C. § 1011, the adjusted basis of property is generally the cost of such property under I.R.C. § 1012, adjusted as provided in I.R.C. § 1016.

Treas. Reg. § 1.165-7(b)(1) states that the amount of loss to be taken into account for purposes of I.R.C. § 165 shall be the lesser of either (1) the reduction in the fair market value of the property on account of the casualty, or (2) the amount of the adjusted basis prescribed in Treas. Reg. § 1.1011-1 for determining the loss from the sale or other disposition of the property involved. However, if property used in the trade or business or held for the production of income is totally destroyed and if the fair market value before the casualty is less than the taxpayer's adjusted basis in the property, the amount of the adjusted basis is treated as the amount of loss. Treas. Reg. § 1.165-7(b)(2)(i) states that a loss incurred in a trade or business or in any transaction entered into for profit shall be determined under subparagraph (1) by reference to the "single, identifiable property" damaged or destroyed.

Treas. Reg. § 1.611-3(c)(1) requires every taxpayer claiming a deduction for depletion of timber property to keep accurate ledger accounts recording the cost or other basis provided by I.R.C. § 1012 of the property and the land together with subsequent capital additions and adjustments under I.R.C. § 1016. Treas. Reg. § 1.611-3(c)(2) states that in such accounts there shall be set up separately the quantity of timber, the quantity of land, and the quantity of other resources, if any, and a proper part of the total cost or value shall be allocated to each after proper provision for immature timber growth under Treas. Reg. § 1.611-3(d).

Treas. Reg. § 1.611-3(d)(3) provides that the total value or total cost, as the case may be, of land and timber shall be equitably allocated to the timber and land accounts respectively, and that in cases in which immature timber growth is a factor, a reasonable portion of the total value or cost shall be allocated to such immature timber.

Rev. Rul. 66-9, 1966-1 C.B. 39 considered what is the "single, identifiable property" for purposes of Treas. Reg. § 1.165-7(b)(2)(i) and what is the allowable amount as a deduction under I.R.C. § 165 for timber destroyed in a hurricane. The ruling states that in the case of a casualty loss to timber, the "property involved" and the "single, identifiable property" destroyed is the quantity of timber which is rendered unfit for use by reason of the casualty.

With respect to the amount allowable as a casualty loss, the ruling states that the amount allowable due to the destruction of timber by hurricane may not exceed the adjusted basis for determining loss from the sale or other disposition of the quantity of timber which by fair and reasonable estimates is found to be unfit for use by reason of the hurricane. The adjusted basis of the quantity of timber destroyed is determined by multiplying the unit adjusted basis by the quantity of timber destroyed. Under Rev. Rul. 66-9, timber that may be salvaged is not destroyed and thus is not allowable as a casualty loss deduction.

In Harper v. United States, 274 F. Supp. 809 (D.S.C. 1967), aff'd per curiam, 396 F.2d 323 (4th Cir. 1968), the court accepted the Service's position that each measurable unit of merchantable timber (i.e., board feet or cords) was a "single, identifiable property" for purposes of Treas. Reg. § 1.1.165-7(b)(2)(i). Thus, it was held that taxpayers there were entitled to a casualty loss deduction only to the extent of the adjusted basis of such timber destroyed. In Harper, the adjusted basis for each unit of timber was determined by dividing the adjusted basis of the entire tract by the total number of units of merchantable timber on the tract.

In Rosenthal v. Commissioner, 48 T.C. 515 (1967), aff'd, 416 F.2d 491 (2d Cir. 1969), the Tax Court also agreed with the Service that a casualty loss deduction for timber destroyed is limited to the taxpayer's basis in the units of timber destroyed and not to the taxpayer's basis in all the timber on the tract. The Tax Court noted that to allow a deduction for more of the basis of the timber than that applicable to the trees damaged would be to allow a deduction for a loss to trees that were not damaged. The court also allowed no deduction with respect to naturally regenerated young growth and to pulpwood damaged and destroyed by the casualty because the taxpayer had no basis in the young growth and had allocated none of its depletion basis in the timber to the pulpwood as opposed to the merchantable timber.

In affirming the Tax Court's Rosenthal decision, the Court of Appeals emphasized the general interrelationship of the basis principles in I.R.C. §§ 611, 631, 1011, and 165. Because of this interrelationship, the court agreed that the taxpayer's basis in all the timber should be allocated to only the units of merchantable timber, as is done for depletion purposes, and that the taxpayer's casualty loss deduction was, therefore, limited to its adjusted basis in the particular units of merchantable timber destroyed.

Following the Rosenthal and Harper decisions, the Service published Rev. Rul. 73-51, 1973-1 C.B. 75. This ruling considered whether the taxpayer could take a casualty loss deduction with respect to damage to surviving merchantable trees that did not currently reduce units of merchantable timber but that might retard or reduce the quality of subsequent growth of the trees. Citing Rev. Rul. 66-9, Rosenthal, and Harper, the ruling indicated that the "single, identifiable property" destroyed is the quantity of merchantable timber rendered unfit for use by the casualty. Since no existing merchantable timber was rendered unfit for use, the ruling concluded that there was no casualty loss to the timber and thus taxpayer could take no casualty loss deduction.

The position of the Service and the holding of Harper and Rosenthal were rejected by the Court of Claims in Westvaco v. United States, 639 F.2d 700 (1980). There, the court held that the block or district should be used for purposes of the adjusted basis limitation of Treas. Reg. § 1.165-7(b)(2) and that the "single, identifiable property" damaged or destroyed by the casualty was the standing timber (merchantable and nonmerchantable) located in the area of the timber tract or block directly affected by each casualty. In so holding, the court ruled that taxpayer there was entitled to a deduction under I.R.C. § 165(a) for both mortal injuries (injuries which destroy or render timber economically unsalvable) and nonfatal injuries (injuries which are measurable but do not render timber economically unsalvable and would normally not be expected to cause extensive mortality) to standing timber to the extent that the partial damage resulted in a reduction in the fair market value of the "single, identifiable property".

In determining that the "single, identifiable property" damaged or destroyed was the standing timber located in the area of the timber tract or block directly affected by the casualty, the Court of Claims found it significant that cords or board feet were not the units of property normally bought and sold by taxpayer. Further, the court found it significant that taxpayer bought tracts of timber, not primarily for resale, but to supply pulp to its own mills. Based on these factors and others, the court reasoned that the goal (economic reality) of taxpayer and others in the forest products industry is to produce an adequate supply of merchantable timber for the indefinite future and that the value of timberland depends in large part on the land's ability to provide a sustained yield.

With respect to the adjusted basis limitation, although the Court of Claims recognized that basis is assigned to each unit of timber for purposes of the depletion regulations, it reasoned that the manner in which basis is determined for depletion purposes should not dictate how it is determined for casualty loss purposes, because basis for depletion purposes is derivative of I.R.C. § 1011 basis, rather than vice-versa. Further, the court reasoned that the assignment of basis to individual merchantable units of timber, as is made for depletion purposes, should not be done for casualty loss purposes because the volume of merchantable trees changes from year to year. Because, in its view, the only unit that remained constant and identifiable, and that has an adjusted basis that is not changed except by elimination of an asset or by injection of capital, is the block, the court concluded that the block or district should be used for purposes of the adjusted basis limitation of Treas. Reg. § 1.165-7(b)(2).

Aside from rejecting the positions of the Government noted, the Court of Claims also rejected the Government's contention that allowing the taxpayer to use an income method of valuation with respect to nonfatally injured trees whose future growth potential was reduced permitted the taxpayer to anticipate income. The court indicated that the reduction of future growth potential should logically cause some reduction in current fair market value and, presumably, the use of projected income is an accepted method of valuation of timber lands. The court, however, remanded the case to the trial division for a determination of the specific reduction in fair market value of the affected timber blocks. It indicated that the reduction in fair market value of the property was essentially a valuation question, in which all the factors should be taken into consideration, including but not limited to the value of destroyed units of merchantable timber and the value of partial losses resulting from nonfatal injuries to merchantable trees.

After the adverse decision in Westvaco, this office recommended to the Department of Justice that the Government file a petition for certiorari on the basis of conflicts with Harper and Rosenthal. The Solicitor General's Office, however, declined to file the petition. In declining to file the petition for certiorari, the Solicitor General's office indicated that it disagreed with the Government's position in Westvaco and that it was unwilling to authorize appeal of any case in which the Government had the same position.

DISCUSSION

Because of the posture of the Department of Justice regarding appeal of Westvaco, the Service in O.M. 19516 reconsidered its position with respect to a casualty loss deduction of timber by taxpayers in the forest products industry. The Service in O.M. 19516 reached the following conclusions:

(1) For purposes of Treas. Reg. § 1.165-7(b)-(2)(i), the "single, identifiable property" is each unit of merchantable timber destroyed.

(2) The taxpayer can take no casualty loss deduction for damage to merchantable trees that does not currently reduce the value of merchantable timber in the trees.

(3) A taxpayer may take a casualty loss deduction with respect to nonmerchantable trees that are damaged or destroyed only if the taxpayer can show that the fair market value of the nonmerchantable trees was reduced because of the casualty, but such deduction may not exceed the taxpayer's adjusted basis in the nonmerchantable trees.

Upon reconsideration, the Service, in O.M. 19893, reaffirmed the correctness of Rev. Ruls. 66-9 and 73-51 and O.M. 19516; however, it was noted that the court in Westvaco viewed the Service's position with respect to nonmerchantable timber as overly rigid (when it was not); and thus suggested two alternative positions.

Regarding the alternative positions, the first was that the "single, identifiable property" for purposes of I.R.C. § 165 would be the I.R.C. § 611 account or subaccount. Under this approach, the amount of the loss allowed with respect to nonmerchantable timber would be limited to the taxpayer's basis in the deferred reforestation subaccount reflecting its investment in that plantation. No loss would be allowed if the taxpayer does not maintain a subaccount for young growth. The other alternative would be to adopt a flexible approach which would acknowledge that the relevant property unit for purposes of a casualty loss is not necessarily controlled by the regulations under I.R.C. § 611. This approach would permit a deduction for casualty losses to plantations and naturally regenerated young growth using an equitable allocation of basis for those assets and permitting use of either the tree or the acre as the "single, identifiable property" damaged or destroyed. The Interpretative Division subsequently dropped the first approach (as not appreciably different from the Westvaco holding) and developed the second approach in more detail.

After coordination with CC:LR, CC:C, CC:TL, and the ISP field personnel, a position statement incorporating the theme of the second approach was presented to the Department of Justice by the Associate Chief Counsel (Litigation). Specifically, the position statement indicated a willingness on the Service's part to modify its strict approach based on the revenue rulings and to allow alternative computations of the casualty loss based on either the damaged acreage, the damaged trees, or the damaged units as the property damaged or destroyed.

Neither the modified position nor the strict approach based on the Rev. Ruls. 66-9 and 73-51 was deemed defensible by the Department of Justice. This was because it is Justice Department's view that any position taken by the Service should reflect commercial realities and these positions do not. In Justice's view, the economic reality, as suggested by Westvaco is that although timber is measured by the board foot or cord for sale purposes, there is generally no transaction involving one board foot or cord of timber. Furthermore, because of economic realities, a casualty may require the taxpayer to harvest not only the damaged timber but adjoining undamaged timber prematurely. For example, if one side of a valley is affected by a casualty, and normally both sides of the valley would be harvested in a single cutting, then the entire valley might constitute the "single, identifiable property" damaged.

Regarding the tree/acre approach to casualty losses of unmerchantable timber, Justice took the position that this approach was too inflexible to gain support in the courts. It was Justice's belief that although this approach might reflect the way taxpayers account for losses for financial purposes, the tree, acre, and depletion unit are essentially artificial delineations and not necessarily realistic properties.

In sum, Justice has advocated that our litigating position be flexible enough that it would take into consideration contiguous areas not physically damaged by the casualty but nevertheless within an economic unit for commercial purposes. Justice believes that we would encounter grave difficulty in persuading a court to follow the Harper and Rosenthal opinions in the future but, apart from advocating flexibility in our approach, has been noncommittal on any specific principle for measuring a casualty loss. Although Justice might start with a tree/acre unit argument as conceptually correct, Justice probably would "fall back pretty quickly" on an economic unit argument in litigation.

Although in December 1988, a petition was filed in the Tax Court with respect to the disallowance of a casualty loss deduction for damage to timber, the present litigating realities are that (1) the Claims Court because of its national jurisdiction and Westvaco is likely to be the chief forum for adjudicating timber casualty loss issues, (2) the Department of Justice has concluded that the traditional approach is not defensible and will not litigate any case on that basis, and (3) neither of the revised approaches presented to Justice has received its endorsement. Given these realities and the abuse that may result if the effect of the Westvaco decision is not limited, we believe the Service should make one last effort to meet with the Department of Justice in order to determine whether a litigating position can be formulated which is acceptable to Justice and the Service.

As of the last survey of opinion within the Service, which occurred before the recent reorganization of Chief Counsel, the Corporation Tax Division and the Industry Specialist were of the view that the Service should maintain the position as enunciated in the Rev. Ruls. 66-9 and 73-51 and adopted by the courts in Harper and Rosenthal. The Interpretative Division believed that tactically, strict adherence to the published positions would backfire, thus it urged that the tree/acre unit position presented to the Justice Department be argued forcefully in litigation, with an economic approach as a fall back. This division proposed recently that the Service should attempt to limit taxpayers claims of casualty loss to undamaged timber by using the smallest tract of timber that is generally cut and sold

in one operation as the "single, identifiable property" and that with respect to nonmerchantable timber, the taxpayer's loss should be determined by reference to the plantation damaged but limited to taxpayer's basis in the plantation. In light of these differences of opinion within the Service as to the litigation position the Government should maintain in the future, we think before the Service meets with the Justice Department about [redacted] that the ISP group and the various components of the Service having an interest in the matter should meet to determine whether a litigating position can be formulated which is acceptable to the Justice Department and the various Service components.

If (1) a new position or approach is developed from the meeting but is rejected by the Justice Department, or (2) no new position or approach is developed and Justice cannot be convinced to use any of the approaches previously presented to it, and/or Justice proposes an alternative which in the Service's view is unlikely to succeed or to reasonable limit taxpayer's claims of casualty loss to undamaged timber, we recommend that the Service (1) concede the casualty loss issue in [redacted] and any other pending cases, (2) revoke Rev. Ruls. 66-9 and 73-51, (3) revoke O.M.s 19516 and 19893, and (4) seek or consider a legislative solution to the casualty loss issue. To facilitate the meeting recommended, the Forest Products Coordinator, Tax Litigation, will contact the Industry Specialist and the coordinators representing the Service components having an interest in the matter regarding a meeting in the near future.

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